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SUBJECT: SECRETARY PAULSON DISCUSSES BOND MARKET, EQUITY  
CAPS WITH CBRC CHAIRMAN

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#### SUMMARY

1. (SBU) Summary: In an August 1 meeting with Secretary Paulson, China Banking Regulatory Commission (CBRC) Chairman Liu Mingkang reported that China is making significant efforts to step up its AML enforcement efforts, noting that banks are getting a lot tougher.8 Second, he reported that the government, including the CBRC, is ramping up its efforts to meet environmental targets on pollution abatement. Third, Chairman Liu reported how the government is promoting bond market development. Fourth, on rebalancing growth, he noted President Hu's view that GDP growth of 6 percent a year would be sufficient if it could be sustained and geographically balanced, saying that the emphasis now is on quality rather than speed. He also noted the need to achieve better macroeconomic balance between investment and consumption. Finally, he emphasized the significant steps China has recently taken to reduce net exports through tax reform. End Summary.

Bond market development ) a role for foreign credit rating, auditing, and accounting agencies

2. (SBU) Chairman Liu emphasized that to support the development of China's corporate bond market, there is a need for high quality credit rating, auditing, and accounting agencies. He acknowledged that there are a number of foreign credit rating, auditing, and accounting agencies that would like to operate in China but are currently unable to do so due to equity caps. He suggested we put this issue on the agenda for SED III.

3. (SBU) Chairman Liu further noted that bond market development would need to involve the development of a robust secondary market with participation from strategic institutional investors, and noted that more institutional investors from the United States would play a welcome role. He added that foreign trust companies could play a bigger role in helping to channel QDII funds to places like New York and London.

14. (SBU) Liu noted that CBRC has established a task force to assess the performance of 24 foreign bank joint ventures (JVs) involving 33 foreign strategic investors. The assessment will be finished by next March, ahead of the National People's Congress, with the aim of providing proposals on reforms, including changes in equity caps, to the State Council. Chairman Liu noted that the last assessment in 2004 recommended that equity caps be raised from 15 to 20 percent. (Comment: Liu's comments appear intended to signal that raising equity caps in banking is possible in the medium-term but not by SED III. End comment).

15. (SBU) Secretary Paulson also asked if China had considered opening the market to foreign non-bank institutions wishing to do RMB financing. (Comment: Current regulations require that the controlling shareholder of a foreign bank in China must be a commercial bank. End comment). Chairman Liu responded by pointing to the successful turn around of Shenzhen Development Bank (SDB) by Texas Pacific Group, a non-bank financial firm that won control of SDB. End Comment.)

Officials prefer tax reform over currency appreciation  
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16. (SBU) Secretary Paulson commended the steps China has taken to reduce export tax rebates and introduce new taxes on resource intensive exports, but argued that changes in China's currency policies are still needed, noting that it would be more efficient to address large current account surplus through the use of market-determined price mechanisms rather than administrative measures.

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17. (SBU) Chairman Liu responded that Chinese senior officials believe there are three reasons why adjusting tax policies is preferable to more rapid currency appreciation for promoting a reduction in external imbalances. First, China's poor would bear the burden of more rapid appreciation. He specifically mentioned the potential for job losses among migrant workers who work for multinational corporations engaged in low value-added processing trade. Second, he argued that currency appreciation is a blunt policy instrument ) while changes in tax policy can target specific sectors of the economy that are problematic (i.e. heavily polluting or export intensive). Third, he argued that, for targeted sectors, the impact of the tax changes dwarfs that of currency appreciation. He noted that the currency has appreciated 9 percent over about two years, while the tax changes raised steel exporters, costs 19 percent overnight (reflecting the repeal of a 9 percent subsidy combined with the introduction of a 10 percent tax). Chairman Liu reported that China would conduct a post-assessment of the tax changes to determine their impact on net exports.

China seeks advice on environmental consequences of lending  
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18. (SBU) Chairman Liu asked for U.S. assistance in identifying the environmental consequences of lending to different sectors, including any benchmarks or standards that China could use to help systematize environmentally-conscious bank lending. David McCormick committed to follow up on this issue with the CBRC.

19. (SBU) Secretary Paulson's delegation cleared this cable.  
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